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IN THE

Supreme Court of the United States

October Term, 1972
No. 72-599

In the Matter of
LOS ANGELES TRUST DEED & MORTGAGE EXCHANGE, a California corporation, and dba TRUST DEED & MORTGAGE MARKETS, a California corporation,

Bankrupt.

STANLEY A. PHIPPS, JAMES A. A. SMITH, GEORGE E. DANIELSON, Trustees,

Petitioners,

vs.

ASSOCIATE FUNDINGS, INC., a California corporation, BRENTWOOD DOWNS, INC., a California corporation, WESTPORT DEVELOPMENT COMPANY, a co-partnership composed of E. J. CANTILLON and A. W. RABALAIS,

Respondents.

Reply to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Statement of the Case.

The Respondents agree that the Statement of the Case in the Petition is correct *excepting:*

1. We submit that contrary to the Petitioners' statement that the proceedings filed by the Trustees were not "in response to Creditor's Proof of Claim" as stated in the two questions presented. (Pet. p. 2.)

Factually, the proceedings initiated by the Trustees were in the form of a Petition for an Order to Show

Cause and for a turnover order of money. The two Claims of Respondents were injected into the case by way of affirmative defense in Respondents' Answer, as will hereinafter appear.

2. Petitioners erroneously state: "In 1961 Respondents filed Proof of Claim. . . ." (Pet. p. 1, line 1) whereas only two of the Respondents were parties to the claims, the Westport Development Company was not a party to either.

Chronology of Events.

(From Findings of Facts and Conclusions of Law—App. pp. 1-7 and Opinion—App. pp. 12-20.)

1958-1959—Respondents being in the business of land development during this period, Exchange financed seven separate tracts of land which was arranged at different times and on separate and distinct tracts.

December, 1960—Exchange was adjudicated a bankrupt.

January, 1961—The Trustees were elected.

July, 1961—Two claims were filed relating to loans on two of the aforesaid seven tracts, one claim filed by Associates Funding and the other by Brentwood Downs.

Each was based upon monies owed and withheld by Exchange arising from the purchase of notes secured by trust deeds on the two tracts not involved in the counterclaim.

November, 1962—Order of the Referee approving compromise agreement between Mr. and Mrs. Farrell and

the Exchange, which carried an assignment from the Farrells to the Trustees, assigning agreements where various Respondents agreed to pay Farrell 50% of profits arising from five tracts. (Opinion n. 1, App. p. 13.)

July, 1966—Counterclaim filed against Respondents seeking dissolution of the "Joint Ventures" and turnover order for 50% of the profits which amounted to $23,883.00 plus interest earned on five tracts.

October, 1966—Proceedings had before the Referee at the request of the Trustees to "pre-try the controversy" and "narrow the issues". Respondent's Answer was filed (App. p. 16) and oral objection to jurisdiction was made followed by colloquy which is set forth in the Opinion. (n. 5, App. p. 17.)

February 8, 1967—Amendment to Answer above referred to is filed.

November, 1968—A hearing was had resulting in Findings of Fact and Conclusions of Law and Order dated November 19, 1968, ordering judgment as prayed.

ARGUMENT.

Reply to Petitioners' Argument A. (Pp. 7-18.)

In claiming summary jurisdiction attached, Petitioners rely upon the fact of the Respondents filing claims notwithstanding each is unrelated to the transaction upon which the counterclaim is bottomed.

Petitioners concede that three Circuit Courts have held that jurisdiction to hear a counterclaim is not conferred on the Bankruptcy Court by reason of the filing of an unrelated creditor's claim. (Pet. p. 7.)

The cases cited are: *In re Behring v. Behring,* 445 F. 2d 1096 (5th Cir.) 404 U.S. 991 (1971). (Cert. denied), and *In re Carnell Const. Corp.,* 424 F. 2d 296 (3rd Cir.) 400 U.S. 828 (1970) (cert. denied) (*both post Katchen*), and the instant case.

In addition, Katchen (n. 1) refers to *Solar Mfg. Corp.,* 200 F. 2d 327 (C.A. 3d Cir.) and *In re Majestic Radio & Television Corp.,* 227 F. 2d 152 (C.A. 7th Cir. 1955), cert. denied sub. nom. *Dwyer v. Franklin,* 350 U.S. 995, which is later cited by Respondents. Certiorari was denied in all *five* instances.

This Court in *Katchen* stated that it granted certiorari for two reasons: One because of the diversity of views among the Courts of Appeal on the issue involved, and the other the importance of the question in the administration of the bankruptcy laws.

As there is no diversity of views among the Courts of Appeal in five circuits, as heretofore indicated, which are in accord in holding that summary jurisdiction does not attach by reason of the filing of a claim on an unrelated transaction in the absence of consent.

Petitioners cite and quote from *Alexander v. Hillman,* 296 U.S. 222 (1935) where claims were filed by

ex officers of the bankrupt based upon advances made and the Receiver countered, claiming fraud and mismanagement by the ex officers.

Factually, *Majestic* is similar where the Bankruptcy Court held that although the claimant was an adverse party, it had no jurisdiction unless the claimant expressly consented to its jurisdiction and held that the filing of the claim in question did not constitute implied consent to be tried in that Court on a counterclaim arising out of a different transaction.

Majestic directs attention to and points out that the Bankruptcy Act, para. 7, §2, sub. (a), contains the words "except as herein otherwise provided," and goes on to state these words are applicable to the provisions of §23 of the Bankruptcy Act, 11 U.S.C.A. §46.

It is then pointed out that § 23, sub. (b) takes jurisdiction away from the Bankruptcy Court unless the adverse claimant consents to the jurisdiction of that Court.

After referring to the many cases cited by the Trustees (none of which are criticized) which hold that the filing of a Proof of Claim constitutes consent to be sued in the Bankruptcy Court on counterclaims arising out of the same transaction, the Court goes on to state:

> "But no case has been cited, nor have we found any, in which it has been held that a Bankruptcy Court has acquired such jurisdiction of a setoff or counterclaim because the counter-defendant had filed a proof of claim *arising out of a completely different subject matter*. The trustees must concede that the alleged cause of action they seek to have adjudicated in the Bankruptcy Court does not arise from any of the transactions upon which Franklin's claim is based.

> [2] It is obvious that filing a claim in a Bankruptcy Court is an implied consent to summary adjudication by that court of any counterclaims *based upon the subject matter of that claim.* A litigant could hardly claim a recovery on the basis of a certain fact situation without permitting the court to decide *all of the legal consequences of that situation.* No party can invite summary adjudication on only part of the *relevant evidence* relating to the subject matter of the claim." (Emphasis ours.)

Referring back to *Alexander,* we have no quarrel with it; however, the Petitioners stress at great length the influence of this case on *Katchen* and other decisions involving the administration of *bankruptcy estates.* (Pet. pp. 7-9-12.)

At the end of the argument, Petitioners state:

> "After all, a court of bankruptcy is as much a court of equity as was the receivership court involved in that case." (Pet. p. 9), with which we agree.

This case was relied upon by the Trustees in *Majestic* and was there disposed of with the following language:

> "The case of *Alexander v. Hillman,* 296 U.S. 222 56 S. Ct. 204, 80 L. Ed. 192, relied upon by appellants, is not in point because the proceeding before the court there was one of receivership in equity to which Section 23 of the Bankruptcy Act did not apply."

Original jurisdiction in *Alexander* was in the District Court and is an action in equity whereas the chose in action assigned by Farrell to the Trustees constitutes

their entire case and claims and could not be the basis of an action in equity. Even if it were the right of set off and all legal and equitable defenses would be available to Respondents. (Sec. 368, Calif. C.C.P.)

Petitioners refer to and quote from Collier on Bankruptcy (Pet. pp. 16-17) which deals with Sec. 68 of the Bankruptcy Act, 11 U.S.C. Sec. 108, concerning setoff of mutual debts and credits between the bankrupt and creditors. This is to no avail to Petitioners as mutuality does not exist in the present case. The argument states that Collier concluded summary jurisdiction attaches in all cases to decide any counterclaim which is asserted only to reduce or extinguish a claim, nevertheless, it would appear that the same principal should be applied to a permissive counterclaim.

It should be noted at this point that the counterclaim in the instant case was not asserted to reduce or extinguish Respondents' claims.

In referring to "setoff" and to "claim", Collier refers to a "proper" setoff or counterclaim, and to a claim that is a "proper" subject of setoff or counterclaim.

The Trustees in *Majestic* advanced the same argument regarding setoff and mutuality and the Court held that they could not successfully argue that Sec. 68, sub.(a) allows the counterclaim which was there, and is here, involved. Sec. 68 is quoted and followed by:

> "If mutual debts were involved here, of course the Bankruptcy Court could offset them, but the question the Trustees want adjudicated is whether or not there are mutual debts (i.e., whether Franklin owes anything to the estate) and Section 68

does not give the Bankruptcy Court jurisdiction to determine that question. In re Montgomery Bros., D.C., 51 F. 2d 284, 285."

Admittedly, mutuality is not present in the instant case and the Referee so concluded, saying, in part:

". . . Respondents cannot offset their claims against the Bankrupt . . . since the debts are not mutual obligations as required by Section 68", and gives as one of three reasons that the debt of the bankrupt and *Farrell's* claim for profits "are not mutual obligations since the bankrupt corporation and Farrell *are different and distinct entities.*" (Emphasis added.) (App. p. 6 Conclusion of Law VI.)

We agree that Farrell and the bankrupt are different and distinct entities. However, the bankrupt, as assignee of Farrell, stands in Farrell's shoes and therefore is limited to assert only the claims which Farrell could assert by reason of the chose in action he assigned.

Conversely, it is open to Respondents to rely upon any frailties existing in Farrell's claim and to assert any and all defenses which might have been asserted against Farrell.

Although the foregoing is academic we, in support of above, cite:

Door Pump & Mfg. Co., 125 F. 2d 610 (Wis. 1942);

Goldie v. Cox, 130 F. 2d 695 (Minn. 1942).

The petitioners rely on General Order in Bankruptcy No. 37 and Federal Rules of Civil Procedure 13(b) as further support for their claim that summary jurisdiction attached because of the filing of the claims by Respondents (Pet. p. 17).

A complete answer is found in *Majestic,* wherein the Trustees advanced the identical argument. In rejecting it, the Opinion states:

> "The trustees' argument that Rule 13(b) of the Federal Rules of Civil Procedure, 28 U.S.C.A., providing for 'permissive' counterclaims gives the Bankruptcy Court jurisdiction of their counterclaim is without merit. The Federal Rules of Civil Procedure apply to cases in bankruptcy only in so far as they are not inconsistent with the Bankruptcy Act. General Order in Bankruptcy No. 37, 11 U.S.C.A. following § 53. And, of course, the Federal Rules cannot enlarge the jurisdiction of any court. United States v. Sherwood, 312 U.S. 584, 589-590, 61 S.Ct. 767, 85 L.Ed. 1058."

Reply to Petitioners' Argument: "B. Section 2a(7) of the Bankruptcy Act Does Not Apply". (Pet. pp. 18-20.)

Petitioners argue that the Court as an alternative basis for its decision considered § 2a(7) and that such consideration is more or less of a make weight which, by implication, results in giving a potential claimant two chances of avoiding summary jurisdiction.

Petitioners state that there is no reason for the application of this section once a claim has been filed, which is true, assuming the claim is related to the transaction upon which the counterclaim is asserted. They lose sight of the Referee's Conclusion of Law No. XI, wherein he gives *two* reasons for concluding that summary jurisdiction attached, namely ". . . by reason of the filing of the claims in this estate by the Respondents, *and* by consent in their litigating this controversy". (App. p. 7.)

Accordingly, the Court was obliged to consider the evidence and the law in determining whether or not the Referee's conclusion was proper in each and both respects.

On the question of consent, § 2a(7) was considered to determine whether Respondents did in fact waive or fail to object to jurisdiction which resulted in Respondents consenting to jurisdiction.

The Court, in reaching its determination that the objection was just as timely and effectively made as if it had been in Respondents' Answer (but made by

amendment), that the Trustees were not misled and that granting Respondents leave to object by amendment was appropriate, that the Court of necessity was required to and did consider pertinent facts from the record and in part quoted therefrom.

Additionally, reference is made and given consideration to Collier on Bankruptcy, Rules 12(h) and 15(a) of the Federal Rules of Civil Procedure, and local Bankruptcy Rule 203, the latter being quoted by Petitioners in Petition, pp. 4 and 5.

Petitioners do not seem to attack the second part of the Opinion in view of their statement that § 2a(7) does not apply, they do however as hereinbefore stated, quote § 203(a) of the Bankruptcy Act which section, as hereinbefore stated, is dealt with in the Opinion in the instant case.

In view of this, and in support of our position, we cite the case of *In re Pennington*, 339 F. 2d 583 (6th Cir. 1965) where the identical two points here were involved.

There, the Trustees appealed from an adverse decision, claiming that summary jurisdiction had attached by reason of Respondent's claim and that the Respondent had consented to summary jurisdiction.

On appeal, the Court held that the appearance by Respondent's counsel at a hearing, and there making an oral objection to summary jurisdiction, *did* not equate the filing of a claim which would result in consenting to jurisdiction.

The claim of the Trustees that § 2a(7) conferred jurisdiction by consent by reason of the oral objection of counsel, and that the filing of written objection six weeks after the counterclaim was filed, did not satisfy the requirements of the section; therefore, consent was given.

In reply to this argument, the Opinion states:

> "Section 2, sub. a(7), dealing with the jurisdiction of courts of bankruptcy, contains the specific qualification 'except as herein otherwise provided.' Appellant ignores this qualification in his argument. In *Williams v. Austrian*, 331 U.S. 642, 644, 649, 67 S. Ct. 1443, 91 L. Ed. 1718, the Supreme Court held that this exception had reference to Section 23 of the Bankruptcy Act hereinabove discussed."

and thus concluded that the said section was not applicable to the issue presented, and affirmed the lower Court.

This parallels the ruling made in *Majestic, infra*.

ADDITIONAL ARGUMENT.

The Bankruptcy Court Had No Jurisdiction Whatsoever in Enforcing, or Attempting to Enforce, Farrell's Rights, if Any, Under the "Joint Venture" Agreements. This Chose in Action Was Not Owned by the Bankrupt nor Was It, or Its Possible Fruits, in the Bankrupt's Possession at Time of Adjudication.

It cannot be denied that the chose in action, or the possible or probable fruits to be obtained therefrom, was not in the actual or constructive possession of the Bankrupt at the time of adjudication, nor did the Bankrupt have any interest therein at such time.

Farrell was the beneficiary under the contracts, and the chose in action based thereon, and he was the legal owner and holder thereof up to the time the Bankrupt acquired same in November, 1962 (eleven months after adjudication) where an assignment was made by him to the Bankrupt pursuant to a compromise agreement.

In view of this, we believe and seriously urge, and it patently appears the Bankrupt could not assert any claim based thereon except by plenary action outside the Bankruptcy Court. It is academic that the property which vests in the Trustees and becomes subject to jurisdiction of the Bankruptcy Court must be that property which is in the actual or constructive possession of the Bankrupt when the Petition is filed.

If, under the circumstances in this case, the Bankrupt could prevail, it could only be on an assignment of property in which Bankrupt had neither claim nor interest, was acquired after adjudication, and its only interest being by an assignment, either by purchase from or in a compromise of a dispute with a third person.

Conclusion.

Inasmuch as the Circuit Court held that there was a lack of summary jurisdiction, other matters, points and Respondents' Affirmative Defenses germane to this case were before the Referee and the Circuit Court which were not considered by the Court. In view of this, should the Court grant certiorari and thereafter reach a determination in favor of the Petitioners, this Court would of necessity order a remand.

As the Appendix contains the order of the Court made on November 19, 1968 and the Findings of Fact and Conclusions of Law upon which said order was based (App. pp. 1-9), we direct this Court's attention to the various matters before the Referee, which necessitated Findings of Facts and Conclusions of Law.

The following Conclusions of Law show:

Nos. I and II:

That all the assets of the estate vested in the Trustees on December 18, 1960 by operation of law. That among the assets of the estate "which *now* has passed to these Trustees is all of Farrell's interest in the written agreements. . . ."

No. IV:

That the "joint venture" agreements were supported by a valuable consideration.

No. V:

The defense of usury is not available.

No. VI:

Respondents cannot offset their claims because the claims and the profits are not mutual obligations.

No. VII:

That the action by the Trustees is not barred by any statute of limitations.

No. VIII:

That there was no violation of the California Corporate Securities Act.

No. X:

That the evidence did not support "any of the other affirmative defenses raised by the Respondents." See Footnote 1 of Opinion (App. p. 13) for that Court's conclusion from the record, regarding Farrell and the assignment under the compromise agreement.

G. BENTLEY RYAN,

Attorney for Respondents.